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Memorandum

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subject: Treatment of Stock Option Payments made by Parent to Employees of Former Subsidiary

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

Parent =

Sub 1 =

Former Sub =

Month 1 =

Year 2 =

ISSUES

Under the facts presented below, after a parent corporation lost its ownership of the stock of a subsidiary to the subsidiary's creditors in a bankruptcy proceeding:

(1) What is the proper character of a loss resulting from payments on nonqualified stock options by the parent to employees of the former subsidiary?

(2) When stock option payments are made to employees of the former subsidiary, which entity may properly claim a compensation deduction for such payments?

CONCLUSIONS

1. Payments on the options have the effect of increasing the parent's basis in the subsidiary stock that became worthless in the bankruptcy. Therefore, the parent's loss in the later year has the same character as the original worthless stock loss, that is, a capital loss under § 165(g)(1) of the Internal Revenue Code.

2. The former subsidiary that employed the employees (or the successor in interest of the former subsidiary) is the proper entity to claim a compensation deduction for the stock option payments under §§ 83(h) and 162.

FACTS

Parent, a holding company and the common parent of a consolidated group, owned before Month 1 of Year 2 two primary subsidiaries, Sub 1 and Former Sub. Sub 1 remains a subsidiary of Parent, but in Month 1 of Year 2 Parent's equity interest in Former Sub was completely cancelled after Former Sub emerged from Chapter 11 bankruptcy proceedings. Former Sub's creditors received all of its equity interest at the end of the bankruptcy proceeding. Former Sub was liquidated in subsequent years. Parent initially claimed a capital loss in the amount of the cancelled Former Sub stock.

Parent had a stock option plan which generally granted nonqualified stock options (options) to certain employees of its consolidated subsidiaries, including Sub 1 and, during its period of consolidation, Former Sub. For purposes of this memorandum, we assume that the options did not have a readily ascertainable fair market value (within the meaning of § 1.83-7(b) of the Income Tax Regulations) at the time they were issued. While the issuance of these options to employees of Former Sub ceased after Year 2, these options generally provided for a ten year window after the date of grant for the exercise of the options. Although Former Sub has been liquidated, these former employees/option holders continue to exercise their options within the permitted option exercise window period.

Procedurally, when an employee exercises his stock option grant, which includes the right to receive payment of the inherent value of these stock options (i.e. the difference between the current fair market value and the value of the Parent stock at the time of the grant), Parent would sell newly issued shares sufficient to cover the payment option being exercised, and use the sales proceeds to pay the value of the option, less applicable withholding taxes, directly to the option holder. Parent reported compensation income paid to the employee for the options exercised and paid within the respective calendar year on Form W-2.

Prior to Month 1 of Year 2, Parent treated these stock option payments the same for Sub 1 and Former Sub. In essence, Parent would render payment to the stock option holder and treat such payment as a capital contribution to the subsidiary employing the stock option holder. The subsidiary would, in turn, take a compensation deduction. This is how Parent continues to treat stock options exercised by employees of Sub 1.

Beginning after Month 1 of Year 2, however, Parent began reporting capital losses for the amount of stock options payments made to former employee option holders of Former Sub within the respective years of exercise. After filing the consolidated returns for years after Year 2, Parent submitted an informal claim for refund, claiming that the stock option payment should be ordinary losses.

LAW AND ANALYSIS

Under § 83(a), when property is transferred to a person in connection with the performance of services, the service provider must include in gross income an amount equal to the fair market value of such property, less the amount (if any) paid for the property. Section 83(e)(3) provides that § 83 does not apply to the grant of an option without a readily ascertainable fair market value.

Under § 83(h), the service recipient is allowed a deduction under § 162 in an amount equal to the amount included in the service provider's gross income under § 83(a). Where the property is substantially vested on transfer, the deduction is allowed in accordance with the service recipient's method of accounting (in conformity with §§ 446 and 461). See § 1.83-6(a)(3).

Section 1032(a) provides, in part, that no gain or loss is recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation. Under § 1.1032-1(a), for purposes of § 1032(a), a transfer by a corporation of its own stock as compensation for services is considered a disposition for money or other property. Thus, when a corporation compensates employees with its own stock, the corporation does not recognize gain or loss under § 1032.

Section 1.1032-3 generally provides that in certain transactions in which a corporation (the acquiring entity) acquires money or other property in exchange, in whole or in part, for stock of a corporation (the issuing corporation), the acquiring entity is treated as purchasing the stock of the issuing corporation from the issuing corporation for fair market value with cash contributed to the acquiring entity by the issuing corporation. If the issuing corporation receives money or other property in payment for its stock, the amount of cash deemed contributed is the difference between the fair market value of the issuing corporation stock and the amount of money or fair market value of other property that the issuing corporation receives as payment. Section 1.1032-3 generally enables a corporate subsidiary to obtain a fair market value basis in parent stock contributed to the subsidiary's capital if the subsidiary disposes of the parent stock in a taxable transaction immediately after it is received from the parent. Thus, as a result of the operation of § 1.1032-3, a subsidiary generally does not recognize gain or loss on the immediate transfer of parent stock to the subsidiary's employee. Under § 1.1032-3(d), the rules of the regulation apply to options issued by a corporation to buy its own stock in the same manner as it applies to stock of an issuing corporation. See § 1.1032-3(e), Example 8.

Rev. Rul. 2002-1, 2002-1 C.B. 268, concerns the tax consequences relating to nonqualified stock options and restricted stock when a subsidiary's stock was distributed by its parent to the parent's shareholders in a "spin-off" transaction qualifying under § 355 of the Code. Among its ruling's fact situations is the following: In Year 1, when D corporation (the parent) owned all the stock of C corporation, D issued a nonqualified stock option to buy D's stock to B, an employee of C. In Year 3, D distributed all the stock of C to D's shareholders in the spin-off. As part of the spin-off, B's option to buy D's stock was cancelled and replaced with options to buy D stock and C stock (the post-division options). The post-division option that B held in D stock required B to pay the exercise price directly to D in exchange for the D stock. In Year 6, B exercised the post-division options.

Rev. Rul. 2002-1 holds that the characterization of the events that occur in Year 6 should reflect the ownership by D of the C stock that existed in Year 1 and continued until immediately before the spin-off. Cf. Rev. Rul. 83-73, 1983-1 C.B. 84 (applying a relation-back principle to characterize indemnity payments made by former shareholders of a merged corporation to the acquiring corporation). Specifically, under the rules of § 1.1032-3, when B exercises the option and receives D stock, the D stock is deemed purchased by C for an amount of money equal to the value of the D stock, no gain or loss is recognized by C, and C is then treated as paying the D stock to B as compensation for services. B includes the value of the D stock (in excess of what B paid for it) as compensation income, and C is allowed a corresponding deduction under §§ 83(h) and 162.

In this case, Parent issued nonqualified stock options in Parent stock to former Sub's employees when Former Sub was Parent's subsidiary. The Former Sub's employees exercised the options after Former Sub was no longer affiliated with Parent, and acquired cash in the value of the stock option. Under the relation-back doctrine, the treatment of these transactions should be the same (as far as possible) as they would be when Parent was affiliated with Former Sub.

If Parent was affiliated with Former Sub when Parent paid cash in the value of Parent stock to the employee of Former Sub, the payment to the employee would have been treated as a capital contribution of the cash by Parent to Former Sub, and Former Sub would be treated as paying the cash to the employee. Former Sub would have had a compensation deduction for the payment of the cash under § 83(h). These principles are derived from § 1.1032-3, which logically applies the same to a stock option settled with cash as a stock option settled with Parent stock. The cash payment would have increased the basis of its stock in Former Sub. When Former Sub later went bankrupt and Parent lost ownership of Former Sub to its creditors, the increased basis from the capital contribution would have increased Parent's worthless stock deduction.

In this case, where Parent paid the ex-employee of Former Sub after Parent lost ownership of Former Sub, the cash payment, treated under the relation-back doctrine as a capital contribution to Former Sub, would have increased the basis of Parent's stock in Former Sub (and therefore Parent's worthless stock deduction). Therefore, Parent's loss from the payment to the employee in the later year has the same character as the original worthless stock deduction; that is, a capital loss under § 165(g)(1). The Bankruptcy Court ruled that Parent is not entitled to an ordinary loss on the worthless stock.

The taxpayer argues that the recent Tax Court decision in Santa Fe Pacific Gold Company v. Commissioner, 132 T.C. No. 12 (2009) requires a conclusion that Parent's loss is an ordinary loss. We do not agree. In Santa Fe the taxpayer, faced with a hostile takeover bid from Corporation A, tried to defend itself by merging with Corporation B. The merger contained a termination fee that the taxpayer would have to pay if it abandoned the merger. The taxpayer ultimately was purchased by Corporation A, whose bid was higher, after its board concluded that its fiduciary duty to its shareholders compelled it to accept Corporation A's offer. It paid the termination fee to Corporation B. The Tax Court held that the taxpayer obtained no long-term benefits from the termination fee payment that would require capitalization under § 263, and therefore allowed an ordinary deduction under § 162. As an alternative holding, the Tax Court allowed an ordinary loss under § 165 because the taxpayer abandoned a capital transaction when it abandoned the merger with Corporation B.

The taxpayer argues that Parent's payments relating to the exercise of the stock options produced no long-term benefits to Parent, and therefore Parent can deduct the payments as ordinary deductions. Alternatively, the taxpayer argues that the loss arose from an abandoned capital transaction and so is deductible under §165.

This case does not concern a payment in a transaction that was cancelled or abandoned. It also does not involve a payment for an expense of Parent itself. Rather, it concerns a stock option plan in which Parent was assisting Former Sub in providing deferred compensation for valuable services provided to Former Sub when it was affiliated with Parent. The compensation expenses were Former Sub's, not Parent's. As explained above, the payments by Parent would have been capital contributions to Former Sub if the payments were made while Former Sub was still affiliated with Parent. Those capital contributions would increase Parent's basis in Former Sub, and therefore its worthless stock deduction if Parent later lost its interest in Former Sub to bankruptcy. In this case, treating the payments as a capital loss to Parent after the bankruptcy produces the same result as if the payments were made before the bankruptcy.

The second issue is which entity is the proper party to take the § 83(h) deduction for the stock option payment. Both Regs. §§1. 83-6(d) and 1.1032-3 indicate that the parent that pays stock (or the cash value of the stock option) to the employee of a subsidiary is treated as making a capital contribution to the subsidiary, not compensating the employee. The subsidiary is treated as compensating the employee. Accordingly, we conclude that Former Sub is the proper party to deduct the payment. We understand that Former Sub has liquidated, but it may have a successor in interest that is entitled to the deduction.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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Please call Stephen Cleary at (202) 622-3782 if you have any further questions.

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